

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

A REVIEW OF THE RATES AND CHARGES)
AND INCENTIVE REGULATION PLAN OF)
SOUTH CENTRAL BELL TELEPHONE COMPANY)

CASE NO. 90-256
PHASE I

O R D E R

Procedural Background

On September 30, 1988, the Commission issued an Order in Case No. 10105¹ approving an experimental Incentive Regulation Plan ("Incentive Plan") for a period of 2 years. In that Order the Commission stated that at the end of the 2-year trial period, South Central Bell Telephone Company ("SCB") would be required to file a rate case and the Commission would concurrently evaluate the results of the experimental Incentive Plan to determine if incentive regulation was in the public interest and should be continued.

To assist in the review of the experimental Incentive Plan, the Commission initiated an audit of the plan and its results through an independent consulting firm, Theodore Barry & Associates ("TB&A"). TB&A's Incentive Regulation Review Report ("TB&A Report") was released to the public on September 4, 1990, and has been incorporated into this proceeding. On September 6, 1990, the Commission initiated this investigation, and SCB was

¹ Case No. 10105, Investigation of the Kentucky Intrastate Rates of South Central Bell Telephone Company, Inc.

directed to file testimony and certain financial data. SCB filed its testimony on October 17, 1990, and additional financial information was filed November 1, 1990.

The Attorney General, by and through his Utility and Rate Intervention Division ("AG"), MCI Telecommunications Corporation, Inc. ("MCI"), GTE South Incorporated ("GTE South"), AT&T Communications of the South Central States, Inc. ("AT&T"), AmeriCall Systems of Louisville, Contel of Kentucky, Inc. ("Contel"), the Independent Group,² Kentucky Public Communications Association, Inc., and Kentucky Coin Pay Phonesinc are intervenors in this proceeding.

On October 1, 1990, SCB filed a motion to adopt a revised Incentive Plan and to defer rate design. SCB claimed the experimental plan had provided a number of benefits, including rate reductions, fair and reasonable company earnings, continued quality of service, enhanced Commission oversight and efficient regulation. Based upon these claims, SCB argued that a review of incentive regulation in the context of a rate case was not necessary. SCB concluded that the experimental Incentive Plan had met or exceeded the objectives outlined in Case No. 10105 and that this investigation should be concluded and incentive regulation

² Ballard Rural Telephone Cooperative, Inc.; Brandenburg Telephone Company; Duo County Telephone Cooperative, Inc.; Foothills Rural Telephone Cooperative; Harold Telephone Company; Highland Telephone Cooperative, Inc.; Logan Telephone Cooperative, Inc.; Mountain Rural Telephone Cooperative; North Central Telephone Cooperative, Inc.; Peoples Rural Telephone Cooperative; South Central Rural Telephone Cooperative; Thacker-Grigsby Telephone Company; West Kentucky Rural Telephone Cooperative.

continued by incorporating certain modifications recommended in the TB&A Report. SCB suggested that the capital markets be reviewed to validate the existing returns on capital which trigger the various sharing ranges. SCB also suggested that rate design issues be deferred until the conclusion of Administrative Case Nos. 285³ and 323.⁴

On October 8, 1990, MCI filed a motion requesting that a procedural schedule be adopted and asked for clarification of the role of TB&A. On October 10, 1990, MCI filed a response to SCB's motion to adopt a revised incentive regulation plan and defer rate design. MCI objected to allowing an incentive regulation plan to continue in effect without giving the parties an opportunity to present evidence through an orderly procedure allowing due process. On October 15, 1990, SCB replied to MCI's response stating that MCI mischaracterized SCB's October 1, 1990 motion. SCB stated that it fully expected the Commission to conduct hearings on the Incentive Plan and to give the parties an opportunity to be heard. SCB again stated that the Commission should defer the issue of rate design to a later date.

On October 25, 1990, the Commission entered an Order which granted SCB's October 1, 1990 motion and set forth a procedure to

³ Administrative Case No. 285, The Investigation Into The Economic Feasibility of Providing Local Measured Service Telephone Rates in Kentucky.

⁴ Administrative Case No. 323, An Inquiry Into IntraLATA Toll Competition, An appropriate Compensation Scheme For Completion Of IntraLATA Calls By Interexchange Carriers, and WATS Jurisdictionally.

review whether incentive regulation should be continued for SCB and whether there were modifications necessary to the experimental Incentive Plan. The Commission deferred the issues of a rate case and rate design priorities until later phase(s) of the proceeding. The procedural schedule set forth in the October 25, 1990 Order was modified several times at the request of certain parties.

Following the October 25, 1990 Order, additional information was requested and provided, prefiled testimony was provided by several intervenors, and SCB provided additional prefiled testimony. A hearing was held on February 12 and 13, 1991. Briefs were filed on March 11, 1991. All information requested has been submitted on this phase of the proceeding.

The Commission determines that incentive regulation is in the public interest and should be continued for SCB. Described herein are necessary changes, modifications, and deviations from the experimental Incentive Plan. A procedural schedule for determining appropriate rate design priorities is included.

Continuation of Incentive Regulation

In establishing the experimental Incentive Plan in 1988, we believed that the potential advantages outweighed the disadvantages and decided that an experimental plan would provide all parties the opportunity to assess incentive regulation. To aid in the assessment of the experimental Incentive Plan, the Commission hired TB&A to conduct a detailed examination of the Incentive Plan and SCB's results in achieving greater efficiencies as a result of the adoption of the plan. TB&A's focused review, which began in April 1990 and was completed in August 1990, concluded that

incentive regulation should be continued with modifications to the experimental Incentive Plan in order to maximize benefits to SCB ratepayers and shareholders equally.⁵ TB&A also concluded that the introduction of the experimental Incentive Plan has, in part, accomplished each of the Commission's stated objectives, noting that SCB earnings exhibited consistent growth; telephone rates were reduced by approximately \$5.7 million during the operation of the experiment; efforts were made by SCB to improve its organization, planning, resource allocation, and operations; and communication between SCB personnel and PSC staff has occurred on a regular basis.⁶

SCB advocated the continuation of incentive regulation as an alternative to traditional regulation, and urged the Commission to adopt a revised Incentive Plan consistent with the recommendations in the TB&A audit after reviewing the capital markets and completing a separate proceeding on rate design priorities.⁷ SCB identified a number of benefits realized as a result of incentive regulation, including decreased telephone rates, increased earnings, increased cost control and innovation, enhanced economic development in Kentucky, and reduction of regulatory lag.⁸ SCB urged the adoption of a revised Incentive Plan which incorporates TB&A's proposed modifications; continues the existing earnings

⁵ TB&A Audit Report filed September 4, 1990, page III-4.

⁶ Id., page IV-6.

⁷ Dickson Testimony, filed October 17, 1990, pages 15-16.

⁸ Id., pages 3-16.

ranges; uses actual capital structure and makes no accounting adjustments; and defers all rate design issues to Phase II of this proceeding.⁹

Various intervenor groups expressed differing levels of support for the continuation of incentive regulation. GTE South and Contel supported the continuation of incentive regulation, although both expressed reservations regarding the impact on other local exchange companies of possible reductions in toll rates.¹⁰ MCI did not oppose continuation of incentive regulation so long as certain modifications were made, including immediate access charge and toll rate reductions, a new target rate of return, specific Commission "policy adjustments" to revenues and expenses, and increased ratepayer access to SCB plan-related data.¹¹ AT&T expressed no objection to the continuation of incentive regulation but stressed that continuation should be conditioned on the immediate reduction of toll and access charges as proposed by SCB and modification of the schedule for rate decreases by placing access and intraLATA toll as the top priority items.¹² The AG did not oppose continuation of incentive regulation, although he did offer testimony relative to the rate of return and stated that

⁹ SCB Brief filed March 11, 1991, page 31.

¹⁰ Briefs of GTE South and Contel filed March 11, 1991.

¹¹ MCI Brief filed March 11, 1991.

¹² AT&T's Brief filed March 11, 1991, page 4.

other revenue issues needed to be examined in any continuation of the experimental Incentive Plan.¹³

Cost of Capital and Earnings Ranges

The Commission finds that it is necessary to review SCB's current capital costs and establish a reasonable capital structure to establish appropriate neutral and sharing ranges in the revised Incentive Plan. Below is the Commission's analysis and determination of these factors.

Return on Equity

In Case No. 9160,¹⁴ the Commission authorized a return on equity ("ROE") of 14.0 percent. This remained the authorized return for SCB with the implementation of the experimental Incentive Plan in Case No. 10105.

SCB proposed an ROE of 16.0 percent.¹⁵ The Discounted Cash Flow ("DCF") method, Capital Asset Pricing Model ("CAPM"), and Comparable Earnings Approach were used by SCB to estimate the return investors require. The AG proposed an ROE of 12.0 percent based on a DCF analysis of the seven Bell Regional Holding Companies ("RHCs").¹⁶

¹³ AG's Brief filed March 11, 1991, page 1.

¹⁴ Case No. 9160, Petition of South Central Bell Telephone Company to Change and Increase Certain Rates and Charges for Intrastate Telephone Service, Order issued May 2, 1985.

¹⁵ Pappanastos Prefiled Testimony, page 10.

¹⁶ Kahal Prefiled Testimony, page 26.

SCB performed a DCF analysis on BellSouth using a quarterly non-constant growth model to estimate its cost of equity capital. Using a closing stock price of \$52 per share, a current quarterly dividend of \$0.67 per share, an initial growth rate of 7.0 percent, and a growth rate of 8.5 percent beginning in 1994, the model produced a required ROE of 13.83 percent. SCB then added 28 basis points to adjust for financing cost to arrive at a DCF cost of equity of 14.1 percent.¹⁷ Applying this same model as of the date of the hearing, SCB arrived at a DCF cost of equity of 14.0 percent including the flotation adjustment.¹⁸

While admitting that the CAPM has been a controversial means of estimating the cost of equity, SCB cited recent revisions in the basic data used to implement the model which makes it feasible to use as a means of estimating its cost of equity.¹⁹ To apply the CAPM equation, SCB used an historical risk premium of 7.2 percent as reported by Ibbotson Associates, BellSouth's beta coefficient of 1.0 as reported by Value Line, and an average Treasury Bond yield of 8.5 percent. After adjusting for flotation cost, the CAPM produced an ROE estimate of 16.0 percent.²⁰ In a further application of the CAPM, SCB substituted an expected risk premium of 7.1 percent, based on the Standard & Poor's ("S&P") 500 or New York Stock Exchange index, for the historical risk premium

¹⁷ Brigham Prefiled Testimony, page 31.

¹⁸ Transcript of Evidence ("T.E."), Volume II, page 86.

¹⁹ Brigham Prefiled Testimony, pages 33-34.

²⁰ Id., page 36.

and derived an estimated ROE of 15.9 percent including the flotation cost adjustment.²¹ At the hearing, SCB revised its CAPM cost estimate down to 15.0 percent due to declines in BellSouth's beta coefficient and interest rates.

Using these two estimation techniques, SCB determined its marginal cost of equity to be within the range of 14.0 percent to 16.0 percent with 15.0 percent being a reasonable point of estimate.²² At the hearing, SCB revised its ROE to be within the range of 14.0 percent to 15.0 percent, with 14.5 percent being a reasonable midpoint.²³

SCB then selected three groups of companies with which to perform comparable earnings analyses.²⁴ The first group consisted of 110 nonregulated companies with debt rated AAA or AA by S&P. The composite 10-year average earned return on book equity for this group ranged from 15.3 percent to 19.0 percent, with an average of 16.8 percent.²⁵ The second group consisted of 86 nonregulated companies with a Value Line safety rank of 1 or 2 and a S&P stock rating of A or A-. The 10-year average ROE for this group ranged from 15.8 percent to 18.4 percent with an average of 16.9 percent.²⁶ The third group was made up entirely by the

²¹ Id., pages 37-38.

²² Id., page 38.

²³ T.E., Volume II, page 86.

²⁴ Pappanastos Prefiled Testimony, page 11.

²⁵ Id., page 13.

²⁶ Id., page 14.

companies in the S&P 400. SCB assumed its equity would be valued at or above book value and thus be in the top quartile of the group. Over the last 10 years the top quartile earned an average of 17.0 percent and the second quartile earned 14.9 percent. Taken together, the top half of the S&P 400 earned an average annual ROE of 16 percent.²⁷ In summation of the three analyses, SCB concluded that comparable earnings during the period 1980 - 1989 ranged from 16.0 percent to 17.0 percent for companies with whom it must compete for capital.²⁸

The AG found the seven RHCs to be a reasonable risk proxy for SCB and applied the standard constant growth DCF model to arrive at a cost of equity for SCB.²⁹ The AG began with a 6-month average dividend yield, for the period ending November 1990, of 5.27 percent and adjusted it upward using an annual growth rate of 7.0 percent to calculate an adjusted dividend yield of 5.5 percent.³⁰ Based upon an earnings retention analysis which yielded a growth rate of 5.6 percent and analysts' projections of 6.3 percent and 6.9 percent, the AG adopted a range of 6.0 percent to 7.0 percent for its growth rate. Using this information, the AG determined SCB's required ROE to be within the range of 11.5

²⁷ Id., page 15.

²⁸ Id., page 16.

²⁹ Kahal Prefiled Testimony, page 8.

³⁰ Id., page 32.

percent to 12.5 percent, with the midpoint of 12.0 percent being a fair and realistic return.³¹

The Commission is obligated to allow SCB an opportunity to earn a rate of return which will allow it to continue to maintain its financial integrity and attract capital. An adjustment for flotation cost and the effective return using a quarterly DCF model would overstate SCB's cost of equity capital. The Commission also has reservations regarding the true comparability of SCB's comparable earnings analysis and the use of risk premium methods to accurately estimate the cost of equity for a public utility. A range of equity returns of 12.5 to 13.5 percent is fair, just, and reasonable. A return in the range of 12.5 to 13.5 percent would allow SCB to attract capital at a reasonable cost and maintain its financial integrity to ensure continued service and provide for necessary expansion to meet future requirements.

Capital Structure

SCB proposed to continue to use its actual capital structure in the measurement of its earnings under a revised Incentive Plan. To support its position, SCB performed a study which showed that a capital structure consisting of 37.0 to 40.0 percent debt and 60.0 to 63.0 percent equity would minimize SCB's total cost of capital and its customers' rates and ensure future access to sufficient amounts of capital in both good and bad economic environments.³² To corroborate the results of its study, SCB performed another

³¹ Id., pages 38-39.

³² Pappanastos Prefiled Testimony, December 17, 1990, page 3.

study which showed that an optimal capital structure would be 35 to 40 percent debt and 60 to 65 percent equity.³³ SCB's capital structure at June 30, 1990 was 38.5 percent debt and 61.5 percent equity, within the range of optimal capital structures determined in its study.³⁴

The AG recommended the Commission employ a hypothetical capital structure of 45 percent debt and 55 percent equity.³⁵ This structure was recommended by SCB and approved by the Commission in several SCB rate cases both before and shortly after the 1984 divestiture of SCB from AT&T. The AG stated that he proposed this capital structure because it was more in line with a pure utility capital structure.³⁶ The AG provided his review of the optimal capital structure studies performed by SCB.³⁷ The AG concluded from his review of these studies that the analyses were flawed and, thus, the structures found optimal by SCB did not minimize SCB's cost of capital and customers' rates.³⁸ SCB challenged the AG's findings and concluded that its studies were statistically sound and that the assertions that a 45 percent

³³ Brigham Prefiled Testimony, October 15, 1990, page 42.

³⁴ Response to Commission Order dated December 3, 1990, Item 7f.

³⁵ Kahal Prefiled Testimony, page 5.

³⁶ T.E., Volume I, February 12, 1991, page 16.

³⁷ Kahal Prefiled Testimony, pages 18-25.

³⁸ Id., page 24.

debt, 55 percent equity ratio would result in a lower cost of capital to SCB were invalid.³⁹

The Commission finds that it is appropriate to use SCB's actual capital structure, and that a hypothetical structure containing only 55 percent equity would not reflect SCB's current competitive conditions nor its expanding capital needs.

However, the Commission also finds that it is appropriate to cap the allowed equity at the current level of approximately 62 percent for the duration of the 3 years of the revised Incentive Plan. This level of equity is in the range found optimal by SCB and should produce the lowest cost of capital and most reasonable level of rates; therefore, the cap should not be exceeded for purposes of the revised Incentive Plan.

The Neutral and Sharing Ranges

The Commission finds that it is best to use the overall cost of capital as the measurement of earnings. The calculation of cost of capital in the measurement of earnings at the points of test should be identical to the Commission's methodology used to calculate capital structure and cost of debt determined herein.

SCB proposed that the Commission retain the neutral range and the sharing ranges above and below the neutral range approved by the Commission in Case No. 10105.⁴⁰ TB&A suggested that the Commission retain the 150 basis point spread for the equal sharing

³⁹ T.E., Volume II, February 13, 1991, pages 87-94.

⁴⁰ Usery Prefiled Testimony, Exhibit JCU, December 21, 1990, page 1.

(50%/50%) ranges above and below the neutral range and retain the infinite (25%/75%) sharing ranges above and below the equal sharing ranges.⁴¹ TB&A also proposed that to encourage SCB to save and/or not expend additional resources above or below the equal sharing ranges, the rate design priority schedules should be altered to allow increases and decreases on competitive services.⁴² MCI recommended that the Commission set a cap on the upper end of the range to avoid infinite sharing.⁴³

The Commission finds that the neutral range should be 10.99 percent to 11.61 percent cost of capital. This range is based on the capital structure at June 30, 1990 of 61.5 percent equity and 38.5 percent debt; the cost of debt at June 30, 1990 of 8.59 percent and the range of equity returns of 12.5 percent to 13.5 percent found fair, just, and reasonable herein. Within the neutral range, there is no earnings sharing.

The Commission finds that the equal sharing ranges should be 150 basis points above and below the neutral range. On the upper end, equal sharing between SCB and the ratepayers should occur between SCB's adjusted earnings of 11.61 percent and 13.11 percent. On the lower end, equal sharing between SCB and its ratepayers should occur between 10.99 percent and 9.49 percent.

For SCB's adjusted earnings above 13.11 percent, SCB shall retain 25 percent and the ratepayers will receive 75 percent of

⁴¹ TB&A Report, filed September 4, 1990, page III-6.

⁴² Id., page III-8.

⁴³ Post Hearing Brief of MCI, filed March 11, 1991, page 15.

those amounts. To cap the sharing at some level on the upper end would reduce SCB's incentive for efficiency at an arbitrary level and thus be counter-productive. The upper sharing range will remain as it was in the experimental Incentive Plan. The Commission will be continually monitoring SCB and will take immediate action if earnings become unreasonably high.

For SCB's adjusted earnings which fall below 9.49 percent, SCB will absorb 75 percent of the amount and the ratepayers will be required to pay increased rates equal to 25 percent of the amount.

Although the Commission has reservations about continuing the low end of the range, the Commission is persuaded that sufficient safeguards through rate design priorities may be incorporated in the revised Incentive Plan to avoid a loss of incentive.

Adjustments to Earnings

Prior Period Adjustments (Ratcheting)

SCB proposed to include a prior period adjustment mechanism in its revised Incentive Plan. Essentially, this prior period adjustment mechanism, also referred to as "ratcheting," would adjust future earnings by any prior period gains or losses cumulatively. The Commission, in adopting the experimental Incentive Plan in 1988, specifically disallowed the prior period adjustment mechanism as unreasonable because it would result in a change in the prescribed range of returns with each sharing of underearnings or overearnings.⁴⁴

⁴⁴ Case No. 10105, Order dated September 30, 1988, page 21.

TB&A found that a perpetual ratcheting mechanism should not be allowed in the revised Incentive Plan because, in an efficient, fully competitive environment, any cost savings would be eliminated over time. However, TB&A did recommend that:

the prior test period adjustment be modified such that the rapidity in which the adjustment mechanism recaptures previous SCB point of test savings be lessened in the first two subsequent points of test (versus the present plan mechanism) and the full SCB savings from earning above the range be recaptured through price reductions within two years or four points of test.⁴⁵

TB&A based its recommendation of a modified prior period adjustment upon the concept that, in maturing industries, firm specific competitive advantages are largely normalized within two to three years,⁴⁶ suggesting that a recapture methodology be provided which more closely parallels a competitive marketplace.⁴⁷

TB&A stressed competition in recommending its proposed modification. Though there has been an introduction of competition into telecommunications, many of SCB's services are still monopolistic. Thus any cost savings should accrue to both the ratepayers and shareholders, not solely to shareholders. In addition, there was no specific quantification or formula for TB&A's proposed modification, with the exception of an exhibit introduced by SCB during its cross-examination of TB&A.⁴⁸ The

⁴⁵ TB&A Report, page III-8.

⁴⁶ TB&A Response, dated December 17, 1990, to Commission Data Request, Item 7b.

⁴⁷ Id., Item 7a.

⁴⁸ Post-Hearing Brief of MCI filed March 11, 1991, page 9.

exhibit was presented to illustrate the sharing provisions under TB&A's suggested modification.

The Commission continues to believe that the prior period adjustment mechanism is unfair. Moreover, sufficient incentives exist in the revised Incentive Plan making TB&A's proposed modification unnecessary at this time. Accordingly, the Commission denies this specific feature of the revised Incentive Plan proposal but will continue to recognize appropriate revenue normalization between points of test.

Other Adjustments to Earnings

In its September 6, 1990 Order initiating this case, the Commission set forth a list of imputed revenues and expenses both directly incurred by and billed to SCB. The Commission asked SCB whether these expenses should be excluded from or added to earnings in the revised Incentive Plan. SCB stated that imputing the revenues or excluding the expenses in the monitoring process would add to the complexity of the process reducing the incentive provided by the simplicity of the process. Additionally, SCB opined that unnecessary expenses tend to be driven out under incentive regulation, and argued that most of the expenses in question are normal and customary business expenses, the exclusion of which would be inconsistent with competition and incentive regulation. SCB also claimed that these items affect competitive as well as monopoly services and could not be allocated between the two.

Dramatic changes are currently taking place in the telecommunications industry. The Commission must ensure that the

monopoly ratepayer does not absorb expenses which are designed to enhance a company's position in competitive markets. With regard to SCB's arguments against including revenue imputation and expense disallowances in the monitoring process, the Commission is not convinced that such items are completely driven out in the incentive regulation process. Though the expenses in question are normally incurred by a business in a competitive arena, much of SCB's business is not subject to competitive pressures. SCB cannot identify that portion of these expenses which are related to competitive versus monopoly services. The Commission has determined that these expenses should be disallowed and the revenues should be imputed. In order to incorporate this decision in the revised Incentive Plan, SCB should make adjustments to earnings at each point of test for the annual effect of the following items and provide the work papers based on the 9-month actual and 3-month estimated adjustment at each point of test to enable the Commission to examine the supporting calculations. The adjustments to earnings, including those billed from any affiliated company, are as follows:

- Employees concession service as though billed at current rates.
- Directory advertising revenues should be calculated using SCB's prescribed cost of capital at the midpoint of the currently prescribed return on equity.
- Institutional advertising.
- Lobbying expenses.
- Memberships in social and service organizations.
- Expenses associated with educational or cultural activities including donations or contributions to civic or educational organizations.

- Expenses associated with sponsorship of events such as the Atlanta Golf Classic.
- Expenses associated with the Inforum in Atlanta.

Amortization of Inside Wire, Depreciation Represcription and Reserve Deficiency Amortization

SCB's future financial performance will be impacted by two expense changes which will substantially reduce expenses and therefore its revenue requirement, and an expense change which will increase its revenue requirement. The question is whether these expense changes and the resulting revenue requirement impacts should be flowed through to SCB's ratepayers via the revised Incentive Plan or directly to ratepayers in their entirety outside of the revised Incentive Plan.

The first expense change is the expiration of the amortization of inside wire. According to SCB, the expiration of this operating expense will result in a reduced revenue requirement of approximately \$6.9 million.

The second expense change which will reduce SCB's annual revenue requirement is the expiration of the amortization of the reserve deficiency ("RDA") on September 30, 1991. This will reduce SCB's 1991 revenue requirement by \$4.5 million, with an additional \$13.0 million reduction in 1992. The total impact will be a reduction of approximately \$18.0 million on an annual basis. Linked by SCB with the expiration of the RDA is the third expense change, the current "three-way" depreciation represcription. In "three-way" meetings between SCB, the Federal Communications

Commission ("FCC") and this Commission, agreement was reached on new depreciation rates. The Commission hereby authorizes those rates to become effective on January 1, 1991. The effect of this represcription is an increased annual revenue requirement of approximately \$5.0 million.

SCB believes that incentive regulation should incorporate actual financial results, i.e., the Commission should adopt an Incentive Plan "accepting changes in the financial records as they fall without exceptions."⁴⁹ However, SCB urged the Commission to take notice of its decisions in permitting intraLATA toll competition in Administrative Case No. 323 and use these monies to help resolve some of the competitive pricing problems which currently exist in SCB's intraLATA toll and access charges.

Specifically, SCB proposed to apply the \$6.9 million annual revenue requirement reduction associated with the expiration of the inside wire amortization expense to reduce intraLATA toll rates by \$4.6 million and intrastate access charges by \$2.3 million. SCB proposed this decrease be effective immediately.

SCB had a somewhat different opinion when addressing the expiration of the 1991 portion of the RDA and expenses associated with the new depreciation rates. SCB proposed to offset the reduced 1991 RDA revenue requirement of approximately \$4.5 million with the increased revenue requirement from the new depreciation rates of approximately \$5.0 million. This proposal was based on SCB's claim that by offsetting depreciation increases with

⁴⁹ Response to Commission Order dated December 3, 1990, Item 1.

decreases, an appropriate framework for responsible capital recovery is established.

On January 1, 1992, SCB proposes to reduce intraLATA toll rates by an additional \$7.0 million and intrastate access charges by an additional \$5.0 million. SCB also proposes to recognize the assumed but pending implementation of Universal WATS Access Lines and reduce rates by \$1.0 million. These changes would recognize the reduced revenue requirement associated with the expiration of the remaining RDA in 1992.

The Commission concurs with SCB's proposal to segregate the monies associated with the expiration of inside wire amortization. This was an unusual event and warrants being flowed directly and in its entirety to the ratepayers. The reduced revenue requirement associated with these monies will be specifically earmarked under the revised Incentive Plan, as opposed to allowing this reduction to be incorporated into actual financial results at a future point of test.

The 1991 portion of the RDA and the depreciation rate represcription should not be linked. The RDA was an unusual event brought on by rapid technological developments in the telecommunications industry. These developments caused existing equipment including switches and outside plant distribution facilities to become antiquated long before the estimated end of their productive lives. As a result, massive replacement of these facilities was required to stay abreast of the new technology and to provide new services. The end result was significant shortfalls in depreciation reserve balances. In order to rectify this capital

recovery shortfall, the Commission, in Case No. 10105, allowed SCB to amortize the difference between the actual depreciation reserve balance in certain plant categories and the theoretical balance based upon estimated remaining useful lives. Moreover, the Commission does not know if future technology changes will be of such a magnitude as to require the establishment of future RDA's. The monies from the RDA should be flowed directly and entirely to the ratepayers and not considered as ordinary income under the revised Incentive Plan.

Conversely, the depreciation rate represcription is an event occurring in the normal course of business, as a result of continuing depreciation studies conducted by all telephone companies. The Commission finds that the expense impact of the booking of the depreciation rate represcription should be flowed through the revised Incentive Plan.

Until Phase II is concluded, SCB should set aside the monies associated with the expiration of the inside wire amortization which was effective January 1, 1991. SCB should also set aside monies for the RDA when that amortization is complete. These monies will accrue an imputed amount of interest at the current 12-month average of the 3-month commercial paper rate as published in the Federal Reserve Bulletin or the Federal Reserve Statistical Release.

Affiliated Transactions

MCI expressed its concern for the need to make certain adjustments to SCB's earnings to reflect appropriate and reasonable monetary transactions with affiliated entities. MCI

pointed out that TB&A's audit focused on the management of affiliated relationships and should not be substituted for a detailed audit and testing of individual affiliated transactions. MCI further cited the SEARUC audit of BellSouth Services as the type of investigation which is needed to ensure that affiliated transactions are necessary and appropriate. MCI made reference to only one particular adjustment, the revenue imputation to recognize the affiliated relationship between SCB and BAPCO, which the Commission has required as an adjustment in the revised Incentive Plan.

It is conceivable that a utility with the ability to pass its costs on to ratepayers may abuse its position and incur expenditures or forego revenue from transactions with affiliated companies. However, the motivation for this practice is somewhat lessened under incentive regulation and increased competition since SCB has more ability to keep earnings gained from efficiency and less ability to set monopoly prices.

Aside from the earnings adjustments required herein, the Commission has no evidence to indicate that there are unreasonable or unnecessary transactions between SCB and other affiliated entities. Though the Commission will not require further adjustments for other affiliated transactions, careful review of these transactions in our monitoring processes will continue.

True-Up Mechanism

Under the experimental Incentive Plan, earnings and any rate increases or decreases were determined using 9 months of actual data plus 3 months of estimated data. The estimated data is

developed as a part of SCB's budget review process and represents the most accurate forecast of future performance available to SCB. Since estimated data is used, there is a difference between the estimate and actual results for the 3-month period. As a result, under the experimental Incentive Plan, ratepayers did not realize these changes in a timely manner. TB&A recommended that a "true-up" mechanism be developed to more timely correct for the difference in estimated and actual results.

MCI urged the Commission to require SCB to base its earnings on actual data. In the alternative, MCI concurred with TB&A's recommendation to institute a true-up mechanism. MCI suggested that the true-up mechanism be administratively simple but effective and recommended that the true-up process be performed at the subsequent point of test. Under MCI's proposal, the estimated data used at the previous point of test would be compared to the actual data for the same period and any resulting increase or decrease would be incorporated into rate adjustments made at the next point of test. As the additional rate adjustments would be "overdue," SCB or the ratepayers should be "kept whole" by implementation of a carrying charge computed using SCB's overall cost of capital at the midpoint of the authorized return on equity.

SCB believes that a true-up mechanism is not required because implementation of a true-up would add more complexity to the plan, and differences between estimated and actual results have been minor and do not warrant the implementation of a true-up. However, SCB is willing to accept this modification and implement

the true-up feature in the revised Incentive Plan. SCB recommends that the true-up mechanism proposed by MCI be adopted if one is to be required by the Commission. The Commission finds that a true-up mechanism is a desirable feature and will require SCB to incorporate such a mechanism in the revised Incentive Plan approved herein. The mechanism should mirror MCI's recommended proposal.

Quality of Service

The Commission's regulations, specifically 807 KAR 5:061, specify minimum service objectives relating to quality of service which must be met by all local exchange carriers ("LECs"). 807 KAR 5:061, Section 4(4), requires each LEC to file a monthly service objective report with the Commission indicating the LEC's performance in meeting the required service objectives. SCB files its service reports monthly, as do other LECs.

The Commission is concerned that SCB has failed to meet certain of the required service objectives. In particular, 807 KAR 5:061, Section 10(1), requires that telephone utilities fill 90 percent of applications for regular service within five working days of receipt of the order for service. Additionally, 807 KAR 5:061, Section 10(2), requires that telephone utilities fill 90 percent of applications for regrades within 30 days of receipt of the request for regrade. SCB's service objectives for calendar years 1987-1990 are filed in this case as Staff Exhibit No. 1.

SCB acknowledged that it has experienced some difficulty in meeting the service objectives in the area of provision of regular service in some of its operating districts, specifically the

Frankfort, Louisville, Winchester, and Paducah operating districts during various portions of the subject time periods.⁵⁰

Although SCB stated that some of the problems were due to a computer software problem in reporting the results, it also acknowledged that some of the problem is due to a lack of facilities in rural areas. SCB further stated that it is planning to spend \$30 million in outside plant facilities in the rural areas of Kentucky during 1991.⁵¹

SCB also addressed the issue of its difficulties in meeting the service objectives in the area of filling applications for regrades within 30 days of receipt of the request for regrades.⁵² SCB offers one- and two-party service in Kentucky, and as of the end of 1990, had approximately 25,000 two-party lines left in Kentucky.⁵³ SCB stated that the principal reason for this problem is that in several instances, because of lack of facilities SCB has provided two-party service where one-party service was requested. This has resulted in the applicant receiving service, but being counted at the same time as a regrade request.⁵⁴ This has, in turn, resulted in an increase in unfilled regrade requests.

⁵⁰ T.E., Volume I, pages 135-150.

⁵¹ Id., page 140.

⁵² Id., pages 143-147.

⁵³ Id., page 143.

⁵⁴ Id., page 144.

There are two issues involved in the area of quality of service. The first is whether SCB's experimental Incentive Plan has had any impact upon SCB's efforts to comply with the Commission's regulations concerning quality of service and, if so, should the revised Incentive Plan include provisions to reward SCB monetarily if it exceeds service objectives and penalize monetarily if it fails to meet those service objectives. Although SCB stated that it believed such provisions would be possible,⁵⁵ the Commission finds that such provision is not necessary at this time. While SCB has not met the subject service objectives in certain districts in percentage terms, its proof⁵⁶ shows that in absolute numbers, the number of held orders for service is 366 and the number of pending regrade requests is 363 as of the end of 1990. SCB further claimed that, to its knowledge, these numbers are the lowest they have ever been.⁵⁷ There is no evidence that incentive regulation has had any detrimental effect on SCB's efforts to meet the Commission's quality of service requirements.

The second issue involved in the area of quality of service is that irrespective of incentive regulation, SCB has an obligation, at a minimum, to meet the Commission's regulations concerning quality of service. The Commission expects SCB to devote those resources necessary to meet the required service objectives.

⁵⁵ Id., page 136.

⁵⁶ Dixon Prefiled Testimony, page 3.

⁵⁷ T.E., Volume I, page 149.

Total Factor Productivity Measurement

At present, a few of the states that have approved incentive regulation have required the development of a total factor productivity measurement and in some instances have conditioned earnings sharing on the results. Since improved efficiency without decline in service quality is the overriding objective of an incentive plan, the Commission is interested in all processes available to both provide incentive and to measure the resulting level of efficiency. SCB and TB&A were questioned on the need for and usefulness of introducing a measure of productivity as a modification in SCB's revised Incentive Plan. SCB's response was that its earnings were a measure of its performance and that adding a productivity measure to the revised Incentive Plan would only encumber the process.

TB&A did not recommend that the Commission introduce a productivity factor result in the earnings sharing under the revised Incentive Plan. TB&A, in fact, stated that imputation of a productivity adjustment into this type of plan could "seriously" jeopardize the motivation inherent in the plan, if not handled in a very cautious manner. TB&A did state that under a rate cap plan, imputation of a productivity adjustment in the process might be appropriate.⁵⁸

The Commission does not wish to hinder the process or destroy the inherent incentives of the revised Incentive Plan. We do realize that even the best productivity study may not present a

⁵⁸ T.E., Volume II, February 13, 1991, pages 214-215.

completely accurate picture of underlying changes in efficiency. Moreover, a poor study and the resulting measurement could be very detrimental to corporate motivation created by incentive regulation.

While the Commission rejects having a productivity factor result in the earnings sharing, we will consider requiring a productivity study. As TB&A highlighted in its report, it is difficult to quantify the effectiveness or impact of incentive regulation. A productivity study, if properly performed, would add another measure of efficiency on which to gauge the company's performance. It is not inconceivable that price cap regulation will be considered in the future, and experience gained now in the development of an appropriate model to measure changes in productivity would be of future as well as current benefit.

The Commission, after the decision in Phase II of this proceeding, will establish an informal conference with SCB to evaluate the costs and benefits of developing a total factor productivity study.

Duration of the Revised Incentive Plan

TB&A recommended that the Commission approve SCB's revised Incentive Plan for 3 to 5 years.⁵⁹ SCB proposed the Commission adopt the revised Incentive Plan for 4 years.⁶⁰ None of the intervenors commented on the appropriate duration of the Incentive Plan. The Commission will continue the revised Incentive Plan for

⁵⁹ TB&A Report, filed September 4, 1990, page III-4.

⁶⁰ Usery Prefiled Testimony, December 21, 1990, page 3.

3 years after May 31, 1991. Three years will afford SCB sufficient time to integrate the objectives of incentive regulation throughout its operations and decision-making processes. Additionally, 3 years will provide sufficient time for the Commission to review SCB's progress in achieving the objectives of incentive regulation to determine whether the revised Incentive Plan should be continued and/or modified.

TB&A also recommended that the Commission not consider the adoption of the revised Incentive Plan to be either experimental or permanent. The Commission agrees. The Incentive Plan, as modified herein, will continue as agreed to by SCB;⁶¹ and thus, the next point of test will be for the 12 months ending May 31, 1991 and shall be filed on May 1, 1991. At the termination of the 3-year period, the Commission will require SCB to file a formal application to continue, discontinue, and/or modify the revised Incentive Plan with proof to support its request.

Phase II of this proceeding will not be concluded prior to the end of the next point of test of May 31, 1991. Thus, rate design priorities for increases or decreases in rates will not have been established. SCB should proceed to file the required information and determine any aggregate increases or decreases at the May 1, 1991 beginning of the point of test. SCB shall retain the monies for increases or decreases until rate priorities are established. Interest shall accrue at the current 12-month average of the 3-month commercial paper rate as published in the

⁶¹ T.E., Volume I, February 12, 1991, Dixon, page 131.

Federal Reserve Bulletin or the Federal Reserve Statistical Release.

Monitoring and Cost of Capital Reviews

Revised Incentive Plan Monitoring Process

In Case No. 10105, which established the experimental Incentive Plan, the Commission stated that one potential advantage of incentive regulation was that continual monitoring would allow for a current dialogue with SCB. The Commission further stated that:

This should produce a better understanding of SCB's operations by the Commission and a better understanding of the Commission's goals by SCB. This understanding in turn should enable both the Commission and SCB to address problem areas with quicker intervention and more timely action.⁶²

One area of inquiry in the Incentive Plan review conducted by TB&A was an examination of the experimental Incentive Plan monitoring process, including the accuracy and timeliness of SCB's filings, the effectiveness of the PSC monitoring process, and the adequacy of information filed as required by the experimental Incentive Plan. In general, TB&A concluded that SCB and Commission Staff are in compliance with Commission Orders regarding the experimental Incentive Plan monitoring.⁶³ However, TB&A also concluded that "SCBK-KPSC communication remains an area requiring considerable clarification and improvement"⁶⁴ and that "KPSC staff

⁶² Case No. 10105, Order dated September 30, 1988.

⁶³ TB&A Report filed September 4, 1990, page III-3.

⁶⁴ Id., page IV-6.

contact with SCBK personnel has remained formal, in large part attributable to staff's concern with due process, or a legalistic approach to regulation."⁶⁵ To address these concerns, TB&A recommended that the Commission clarify its position on incentive plan monitoring, balancing the needs of all concerned parties, including the Commission, SCB, and potential intervenors.⁶⁶

The Commission agrees with TB&A's recommendations relative to additional monitoring of SCB's operations, particularly the following:

TB&A recommends that the KPSC encourage its staff to take full advantage of on-site monitoring, as well as the general accessibility of SCBK personnel, to become more familiar with the telecommunications industry, in general, and SCBK, in particular. Greater staff familiarity with these issues should enhance staff participation in the quarterly meetings, making that forum more effective. Better KPSC staff preparedness should also greatly alleviate intervenor concerns regarding staff's ability to effectively and thoroughly protect vested party interests.⁶⁷

Significantly, no intervenors contested these recommendations, and no intervenors filed comments to indicate that additional Staff monitoring was inappropriate. In order for incentive regulation to be effective, the Commission Staff must be encouraged to become as informed as possible with SCB's ever changing operations, particularly in the areas of network planning, capital deployment, and marketing. The Commission intends to take the necessary steps to ensure that TB&A's

⁶⁵ Id., page IV-20.

⁶⁶ Id., page V-10.

⁶⁷ Id., page V-11.

recommendations concerning monitoring are implemented expeditiously.

The Commission will take an increased role in on-site monitoring of SCB throughout the duration of the revised Incentive Plan. Moreover, the Commission will require monthly rather than quarterly meetings. These meetings are to focus directly on SCB's strategic planning to meet the objectives of incentive regulation and to improve its relative market position and reduce expenditures. Topics addressed in the non-confidential portion of the quarterly meetings in the experimental Incentive Plan are of only general interest and should be eliminated. SCB is directed to make the Commission Staff aware of information necessary for a complete understanding of SCB's strategic plans, decisions, and operations and its affiliated transactions on an ongoing basis. The AG will be notified at least 5 working days in advance of the meetings and invited to participate.

MCI believes that other intervenors of this proceeding should be permitted to attend the monitoring meetings. The Commission disagrees. In order to effectively monitor SCB, full disclosure is imperative. MCI and other IXCs are competitors as well as ratepayers of SCB. A competitor's presence at these meetings, even under a protective agreement, would hamper SCB's willingness to disclose information.

In addition, TB&A recommended that the current financial reviews be supplemented with a review and intimate understanding of SCB's strategic network and marketing plans, and activities, including but not limited to dry fiber policy, and other

potentially highly competitive technology. The Commission concurs. SCB should make all information on these topics available to Commission Staff in on-site monitoring. Moreover, the monthly meeting format should address these topics in detail highlighting especially management policies and policy changes in these areas.

The monthly meetings are to be scheduled by Staff on or before the 10th day of each month and should be held on or before the 20th day of each month in the Commission's offices.

Information Required In the Monitoring Process

The Commission requires SCB, as a part of its revised Incentive Plan, to file the monthly financial information as set forth in its April 18, 1989 Order in Case No. 89-076.⁶⁸ The information should be filed on the same time schedules required in that Order. Confidentiality of this information has been determined in Orders in Case No. 89-076 and will, without further Order of the Commission, be adhered to for these filings in this case.

MCI requested the Commission require SCB to file its intrastate minutes of use as a part of the quarterly ARMIS reports filed with the Commission. MCI's stated reasons for this recommendation are unclear. The Commission finds such reports unnecessary.

⁶⁸ Case No. 89-076, South Central Bell Telephone Company's Experimental Incentive Regulation Plan.

MCI also has requested that the Commission rule that any ratepayer may obtain and review any plan-related data and documentation.⁶⁹ SCB indicated a willingness to work with MCI to disclose certain information related to the information filed at the points of test.⁷⁰

However, the Commission will not order that plan-related data and documentation be made available to any ratepayer. Much of this information is highly sensitive, and its disclosure would result in the loss of revenues from competitive services, thus, forcing the monopoly ratepayers to pay higher rates.

Cost of Capital Reviews

TB&A recommended the Commission conduct a review of the cost of capital every 2 years.⁷¹ Since the Commission is continuing the Incentive Plan for 3 years, we will conduct a capital review at the end of 18 months. If SCB proposes to retain incentive regulation at the end of the 3-year period, as a part of its application, SCB should provide proof to support its then current return on equity, cost of debt, and its optimal capital structure.

The cost of capital review at the end of 18 months should be initiated by SCB in the form of an application for a new case limited to the purpose of reviewing the cost of equity and the cost of debt, capital structure (not to exceed 62 percent equity)

⁶⁹ Brief of MCI, filed March 11, 1991, page 12.

⁷⁰ T.E., February 12-13, 1991, Volume I, pages 118-120, 157-158, and 190-193.

⁷¹ TB&A Audit Report, filed September 4, 1990, page III-8.

and the resulting earnings ranges. The intervenors in the instant proceeding are to be considered parties to the subsequent cost of capital case.

This case should be filed on December 1, 1992 and served by SCB on all parties to this proceeding. Along with the application, SCB must provide proof supporting the current equity and debt costs. Intervenors will be permitted to file testimony or comments on these issues within 30 days of SCB's filing. The Commission will conduct a hearing or formal conference with all parties and make its determination shortly thereafter.

The Commission encourages the parties to settle these issues prior to filing, if possible. If settlement is reached, SCB may file the signed settlement agreement in lieu of testimony. A hearing on the settlement agreement may be required.

If the review results in changes to the cost of capital and the Commission determines that changes are required in the neutral and sharing ranges, SCB's earnings level will simultaneously be altered through either a rate increase or decrease to leave SCB's modified cost of capital in the same relative position as prior to the review.

Rate Design Priorities

As indicated in its October 25, 1990 Order, the Commission will now establish a procedural schedule to determine the appropriate priority schedule of rate increases and decreases under the Incentive Plan. Although the final Order in Phase I of Administrative Case No. 323 has not been entered, the Commission believes that it is best to proceed with Phase II of this

proceeding. The final Order in Phase I of Administrative Case No. 323 will be issued before the conclusion of this proceeding, and the determinations made therein will be considered in concluding Phase II of this proceeding.

Many of the parties in this proceeding have offered proof on issues that relate directly to the appropriate determination of rate design priorities. MCI has requested the Commission require SCB to follow imputation of access charges in its pricing of intraLATA toll pursuant to MCI's recommendation in Administrative Case No. 323.⁷² The final Order in Administrative Case No. 323, Phase I, has not been entered and MCI's request is premature. However, any constraints required in the Commission's decision in Administrative Case No. 323 will apply to SCB and must be adhered to regardless of the decisions on the revised Incentive Plan.

Several LECs have raised concerns about the intraLATA toll pooling arrangement and have offered alternatives. The current intraLATA pooling arrangement and alternatives thereto are appropriately reviewed in this second phase of the proceeding. All parties wishing to provide proof on this subject should do so in Phase II of the proceeding.

The Commission hereby notifies the parties that the procedural schedule for review and determination of rate design priorities is as follows:

⁷² Brief of MCI, filed March 11, 1991, page 19.

Prefiled Testimony of SCB Due April 22, 1991
Information Requests to SCB Due May 2, 1991
SCB Responses to Information
Requests are Due May 13, 1991
Prefiled Testimony by Intervenors
is Due June 3, 1991
Additional Information Requests
of SCB and Information Requests
to Intervenors are Due June 13, 1991
Responses to Information Requests
are due June 24, 1991
Hearing in Hearing Room 1 of the
Commission's Offices at
730 Schenkel Lane
Frankfort, KY July 16, 1991
at 10:00 a.m.

South Central Bell shall prefile testimony on rate design priorities to be addressed outside the Incentive Plan and rate design priorities to be addressed as part of the Incentive Plan. For items to be addressed outside the Incentive Plan, the prefiled testimony should discuss amounts targeted to specific services, the rationale for the revenue change, implementation dates, and appropriate demand price-out periods, including demand price-out adjustments. For items to be addressed as part of the Incentive Plan, the prefiled testimony should discuss amounts targeted to specific services over the various points of test, the rationale for the revenue change, and appropriate demand price-out periods, including demand price-out adjustments. In both cases, any imminent rate changes should be accompanied by demand price-out information. Also, the prefiled testimony should discuss in specific detail any proposed changes to the operation of the

intraLATA toll pool, including an analysis of the revenue impact on South Central Bell and the other local exchange carriers.

ORDERS

Based on the evidence of record and being otherwise sufficiently advised, the Commission HEREBY ORDERS that:

1. Incentive regulation for SCB shall be continued for a period of 3 years after May 31, 1991.

2. SCB shall file all necessary information for its next point of test on May 1, 1991.

3. If rate design priorities have not been established by May 31, 1991, or by other future points of test, SCB shall set aside any monies for rate increases or decreases and interest shall accrue at the 12-month average of the 3-month commercial paper rate as published in the Federal Reserve Bulletin or the Federal Reserve Statistical Release on and after May 31, 1991 or the final date of any subsequent point of test.

4. All aspects of the Incentive Plan approved by the September 30, 1988 Order which are not specifically modified herein are retained and remain in full force and effect. The Incentive Plan shall be specifically modified as follows:

(a) Range of equity returns is 12.5 to 13.5 percent.

(b) Capital struture is 61.5 percent equity and 38.5 percent debt.

(c) Percent common equity is capped at the current level of approximately 62 percent and shall not exceed 62 percent for purposes of measurement under the revised Incentive Plan.

(d) Neutral range is 10.99 percent to 11.61 percent cost of capital.

(e) Upper end equal sharing range is 11.61 percent and 13.11 percent.

(f) Above 13.11 percent, SCB retains 25 percent and returns 75 percent to ratepayers.

(g) Lower and equal sharing range is 10.99 percent and 9.49 percent.

(h) Below 9.49 percent, SCB will absorb 75 percent and ratepayers will pay increased rates of 25 percent.

(i) SCB shall adjust earnings at each point of test for the annual effect of the items listed on page 18 and 19 above and shall provide workpapers based on the 9-month actual and 3-month estimated adjustment at each point of test.

(j) A "true-up" mechanism is required to correct for the difference between estimated results and actual results. If true-up changes occur, carrying charges at SCB's authorized cost of capital based on the midpoint of the authorized return on equity shall accrue on and after the end date of the point of test preceding the true-up adjustment.

(k) SCB shall meet monthly throughout the 3 years of the revised Incentive Plan with Commission Staff and the AG. Other ratepayers shall not have access to these meetings. These meetings shall be scheduled by Staff on or before the 10th day of each month and shall be held on or before the 20th day of each month in the Commission's offices.

5. SCB shall file an application for a case to review its capital market along with proof supporting its current cost of equity and debt and capital structure and any revised earnings ranges on December 1, 1992. If a settlement has been reached by the parties in this proceeding on these issues, SCB shall file the signed Settlement Agreement.

6. SCB shall set aside monies for the expiration of the amortization of inside wire. These monies in their entirety shall accrue to SCB's ratepayers. Prior to the establishment of rate design priorities, interest at the 12-month average of the 3-Month Commercial Paper Rate as published in the Federal Reserve Bulletin or the Federal Reserve Statistical Release shall accrue on and after the date of this Order.

7. SCB shall set aside monies for the expiration of the amortization of the depreciation reserve deficiency. These monies in their entirety shall accrue to SCB's ratepayers. If rate design priorities have not been established, interest shall accrue at the 12-month average of the 3-Month Commercial Paper Rate as published in the Federal Reserve Bulletin or the Federal Reserve Statistical Release.

8. SCB shall adhere to the Commission's regulations on quality of service.

9. SCB shall meet with Commission Staff after the conclusion of this proceeding to examine the cost and benefits of developing a total factor productivity measurement.

10. SCB is required to make available to the Commission Staff all information necessary to evaluate its strategic plans,

management and operations, especially in the areas of network and marketing.

11. MCI's request for a further investigation of affiliated transactions is hereby denied.

12. SCB shall file the same monthly financial information on the same schedule as required in the Commission's April 18, 1989 Order in Case No. 89-076. Confidentiality ordered as to those reports in Case No. 89-076 shall apply to the filings herein. Said reports shall be retained as confidential.

13. MCI's proposal to include minutes of use data on the quarterly ARMIS reports is hereby denied.

14. MCI's proposal to require that all information and documentation associated with the revised Incentive Plan be made available to any ratepayer is hereby denied.

15. SCB shall file its revised Incentive Plan with the modifications required herein within 20 days of the date of this Order.

16. SCB shall book the new depreciation rates resulting from the most recent depreciation represcription on and after January 1, 1991.

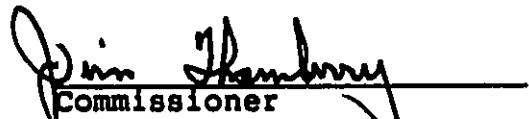
17. The procedural schedule for Phase II, Rate Design Priorities, as established herein, shall be adopted.

Done at Frankfort, Kentucky, this 3rd day of April, 1991.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director